

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0757

**Adjusted Gross Income Tax
For Tax Years 1995 through 1997**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax—Business Income

Authority: The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001); IC 6-3-1-20; IC 6-3-1-21; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; 45 IAC 3.1-1-58

Taxpayer protests the classification of income as business-related.

II. Adjusted Gross Income Tax—Capital Loss

Authority: IC 6-3-4-14; IC 6-3-2-2

Taxpayer protests the denial of a capital loss carryback.

III. Tax Administration—Negligence Penalty

Authority: 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer manufactures major appliances, with operations nationwide. As the result of an audit, the Department of Revenue ("Department") issued proposed assessments for adjusted gross income tax. Taxpayer protests two issues, as well as the ten percent (10%) negligence penalty. Further facts will be provided as necessary.

I. Adjusted Gross Income Tax—Business Income

DISCUSSION

Taxpayer protests the classification of income from the sale of stock in another company as business income. Taxpayer explains that its relationship with the other company, a licensee of taxpayer, was not unitary. There was no common management, functional integration, or economies of scale between taxpayer and the licensee. The Department assessed the income as business income on the grounds that either the underlying property generated business income in the ordinary course of business, or the proceeds served an operation function in the ordinary course of business. The Department referred to 45 IAC 3.1-1-58, which states:

Capital Gains and Losses. Capital gains and losses from the sale of real property formerly used to produce nonbusiness income are allocated to the state where the property is located. Capital gains and losses from the sale of nonbusiness tangible personal property are allocated to Indiana if the property had a situs in the state when sold, or if the taxpayer's commercial domicile is in Indiana and it is not taxable in the state where the property had a situs. Capital gains and losses from sales of nonbusiness intangible property are allocated to Indiana if the taxpayer's commercial domicile is in this state.

Taxpayer claims that the income from the sale of this stock is non-business income since the stock was held for investment purposes only. Business income is defined by IC 6-3-1-20, which states:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

IC 6-3-1-21 states:

The term "nonbusiness income" means all income other than business income.

The Department found that the company whose stock taxpayer disposed of generated royalty income for taxpayer and that royalty income is properly classified as business income. The Department considered the sale of stock in a company with whom taxpayer had a licensing agreement that generated business income to be in the regular course of taxpayer's business.

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The court looks to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or nonbusiness income under the transactional test. These regulations state, "... the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664.

In the instant case, taxpayer sold the stock in a licensee to a competitor in the industry. Taxpayer's business is manufacturing appliances, the income derived from the sale of stock is not substantial compared to taxpayer's overall activities, and the transaction was a one-time sale. Also, the percentage of stock held was insufficient to allow taxpayer to exert control over the licensee indicating an investment purpose in acquiring and holding the property producing income. When all of these factors are considered, the transactional test as described in May is not met.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. at 664. The Court in May defined "integral" as part or constituent component necessary or essential to complete the whole. Id. at 664-5. The Court held that the May's sale of one of its retailing division was not "necessary or essential" to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the Court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

In the instant case, the Department noted the fact that taxpayer received business income from the stock of the licensee. The Indiana Tax Court explained in May:

More importantly, this process (i.e., acquisition, management and disposition) must be *integral* to the taxpayer's regular trade or business operations. It is not enough that the property was used to generate business income for the taxpayer prior to its disposition. The disposition too must be an integral part of the taxpayer's regular trade or business operations.
Id. at 664.

The term "integral" is defined as, "The term in ordinary usage means part or constituent component necessary or essential to complete the whole." Black's Law Dictionary 809 (6th ed.

1991). The documentation does not establish that the sale itself was a part or constituent component necessary or essential to complete the whole of taxpayer's regular trade or business operations. In this case, while owning stock in a licensee may have been advantageous to taxpayer, the owning and selling of the stock was not a necessary or essential component of taxpayer's business of manufacturing appliances.

Therefore, under both the transactional and functional tests provided in May, sale of the stock in the licensee was non-business income. Under 45 IAC 3.1-1-58, capital gains and losses from sales of nonbusiness intangible property are allocated to Indiana if the taxpayer's commercial domicile is in this state. Taxpayer's commercial domicile is not in this state, therefore the capital gains from the sale of nonbusiness intangible property is not allocated to Indiana.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax—Capital Loss

DISCUSSION

Taxpayer protests the denial of credit for a capital loss in 1994, which taxpayer wanted to carry back to 1991 and 1993. The Department denied the carry back on the basis that the loss was the result of taxpayer selling assets of one subsidiary and stock of another, neither of which was listed on taxpayer's Indiana consolidated return. The Department referred to IC 6-3-4-14(b), which states:

For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.

Taxpayer refers to IC 6-5.5-1-2 to support its position that capital losses may be carried back. IC 6-5.5-1-2 applies to financial institutions, while taxpayer is not a financial institution. The statute applicable to taxpayer is IC 6-3-2-2(i), which states:

- (1) Capital gains and losses from sales of real property located in this state are allocable to this state.
- (2) Capital gains and losses from sales of tangible personal property are allocable to Indiana if:
 - (i) the property had a situs in the state at the time of the sale; or
 - (ii) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.
- (3) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

At hearing, taxpayer explained that the Department erred in determining which subsidiary's assets were sold and which subsidiary's stock was sold. In either case, the stock is intangible personal property and is allocated to Indiana if the taxpayer's commercial domicile is in this state, as provided in 45 IAC 3.1-1-58. Taxpayer's commercial domicile is not in Indiana, therefore the capital loss is not allocated to Indiana. The assets are tangible personal property. However, the assets did not have a situs in Indiana, therefore the capital loss is not allocated to Indiana.

In conclusion, the subsidiaries were not included on the consolidated return. As is consistent with the finding in Issue I, the taxpayer's commercial domicile was not in Indiana. The tangible personal property had no Indiana situs. As provided in IC 6-3-2-2(i), under these circumstances the capital loss is not allocable to Indiana.

FINDING

Taxpayer's protest is denied.

III. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty. The relevant regulation is 45 IAC 15-11-2(c), which states in part:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-2.1] if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer has not demonstrated that it exercised ordinary business care and prudence in carrying out its duty to pay income tax. Therefore, taxpayer has not affirmatively established reasonable cause, and the negligence penalty shall not be waived.

FINDING

Taxpayer's protest is denied.